

This record is a partial extract of the original cable. The full text of the original cable is not available.

290854Z Jun 05

UNCLAS SECTION 01 OF 03 TAIPEI 002835

SIPDIS

SENSITIVE

STATE PLEASE PASS AIT/W AND USTR

STATE FOR EAP/RSP/TC, EAP/EP AND EB/IFD/OIA

USTR FOR Audrey Winter and Tim Wineland

USDOC FOR 4420/USFCS/OCEA/EAP/LDROKER  
USDOC FOR 3132/USFCS/OIO/EAP/ADAVENPORT  
TREASURY FOR OASIA/ZELIKOW AND WISNER  
TREASURY PLEASE PASS TO OCC/AMCMAHON  
TREASURY ALSO PASS TO FEDERAL RESERVE/BOARD OF  
GOVERNORS, AND SAN FRANCISCO FRB/TERESA CURRAN

E.O. 12958: N/A

TAGS: [EINV](#) [EFIN](#) [ECON](#) [PINR](#) [TW](#)

SUBJECT: Soft Business Performance Spills to Q2 of 2005

Summary

-----

1. Taiwan's soft economic performance from the first quarter of 2005 spilled over into the second quarter. Weak world demand for Taiwan products has driven y-o-y export growth in May 2005 to a new low and manufacturing posted its most significant contraction since SARS attacked Taiwan in early 2003. Higher petroleum prices and heavy rains together pushed up the inflation rate in May to a new 7-month high. Nevertheless, inflationary pressure is not a concern in light of low money supply growth and declines in price levels for services industries. The unemployment rate in May rose slightly from April, due mainly to new graduates' joining the labor market. Local economists differ in their outlook of economic trends for Taiwan in the next six months. Some suggest the government should stimulate domestic growth rather than relying on export growth. End Summary

Export Expansion Slows, Manufacturing Sector Shrinks

-----

2. Taiwan's export sector, contributing two-thirds of the island economy's GDP in 2004, continued to experience a slowdown in export expansion in Q2. Taiwan's export growth began to decline in the second half of 2004 when world demand for Taiwan products (mainly electronic goods) began to weaken. Y-o-y growth in exports dropped steadily from 28.8% in Q2 of 2004 to 7.8% in Q1 and 7.5% in April and May of 2005. Growth in export orders received by Taiwan also declined from 29.1% in Q2 of 2004 to 14.3% in April and May this year.

3. However, Taiwan's manufacturing firms did not benefit from the 14.3% growth in export orders. Relatively high inventories built up in the second half of 2004 and higher rates of offshore production resulted in a 0.8% decline in manufacturing in May. This is the largest contraction of manufacturing in the past two years. Taiwan's manufacturing production in May 2004 declined 1.7% as a result of SARS on the island.

Offshore Production of Export Orders

-----

4. Many Taiwan business firms have set up production bases overseas, mainly in China. These offshore bases produced 37.7% of export orders in May 2005, slightly down from 39.7% in February but still much higher than 30.7% a year ago. For the information & communications industry, the ratio reached 73%. According to the latest survey of the Industrial Technology Intelligence Services, Taiwan's notebook computer firms, occupying 72% of the global market, are receiving export orders in Taiwan, but only producing 11% of the orders on the island. The remaining 89% is manufactured overseas.

Capital Outflow Cuts Money Supply Growth

-----

5. Offshore production of export orders is a result of a chronic net outflow of direct investment (DI) funds, which continued to prevail in 2005. Outbound DI approved by the Ministry of Economic Affairs in the first five months of this year totaled US\$1,080 million, more than double the

US\$498 million in approved inbound DI. The net outflow of DI totally offset the modest, by Taiwan standards, trade surplus of US\$549 million. The trade surplus in the first five months of 2005 was 87% less than during the comparable period a year ago because import growth of 13.5% greatly exceeded the 7.6% rate of export growth.

16. Capital outflow from the direct investment account in the first five months of 2005 dampened money supply growth and, therefore, helped decrease inflationary pressure. In May 2005, M1b grew at a 5.6% rate, the second lowest in the past 16 months. M2 grew at a 5.9% rate, the lowest in the past two years. M1b is composed of currency held by the public plus deposit money. M2 includes M1b, time deposits, time savings deposits, and foreign currency deposits.

#### Inflationary Pressure Light

17. In May 2005, the consumer price index rose 2.3% from a year ago, the highest in the past seven months. Higher inflation resulted partly from higher oil prices and partly from heavy rains destroying some vegetable and fruit crops. Oil prices rose above US\$50 per barrel in May and US\$60 in June, prompting petroleum-related prices to rise 7.35% for gasoline and 10.5% for petroleum and natural gases, according to the Directorate General of Budget, Accounting and Statistics.

18. In May and June 2005, heavy rains damaged agricultural production in southern and central Taiwan. Agricultural losses caused by floods exceeded NT\$2 billion during these two months. Consequently, produce prices surged 36% for fruits and 21% for vegetables in May.

19. On the other hand, declines of 0.5-1.5% in price levels in the services sector (including housing rentals, entertainment, and beauty services) in May 2005 offset a portion of the increased energy and produce prices. Housing rentals, entertainment, and beauty services constitute 44% of CPI, far more than 8% weighting for energy, fruits and vegetables.

#### Unemployment Rate Rises Seasonally

10. Taiwan's unemployment rate in May 2005 rose to 4.1% from 4.04% in April. It was 4.41% a year ago. The moderate rise in unemployment resulted mainly from the seasonal event of new graduates joining the labor market. Employment has improved, with the number of people employed in May 2005 rising by 0.2% from April and by 1.6% from a year ago.

#### Economic Prospects

11. Local observers differ in their expectations for Taiwan's economy in the second half of 2005. Senior Economist Wu Chung-shu of Academia Sinica is optimistic. He predicts better economic performance in the next six months. Wu says that China, acting as the "factory" for Taiwan firms, continued to enjoy handsome export growth of 34% in the first four months of 2005. In addition, economies of Taiwan's major export markets will continue to grow at a moderate rate. Wu predicted that Taiwan's export growth would return to double-digits in the second half of this year, and that its growth rate could reach 20% in the last quarter. Wu noted that to meet higher export demand, private investment would post double-digit growth that could exceed 20% in Q3 of 2005. A sign for the expected expansion of private investment was a 30% growth in imports of capital goods (excluding aircraft) in May 2005. The growth in machinery imports in the month even reached 54.4%. However, Wu indicated that the trend might turn sour if oil prices should continue to rise and China's Renminbi should significantly appreciate (against the US dollar).

12. Tsai Hung-kun, Deputy Director of the DGBAS' Statistical Bureau, on the other hand is relatively pessimistic. He believes that a slowdown in global economic growth in 2005 will cap Taiwan's export growth at 8% for the rest of this year. Tsai predicted that private investment growth would slow from 15% in Q1 to merely 2.5% in Q4 of 2005.

13. In a recent speech to the Council for Economic Planning and Development (CEPD), Schive Chi, President of the Taiwan Academy of Banking and Finance and former Vice Chairman of CEPD, suggested that the government should stimulate Taiwan's domestic demand rather than rely on export growth. He indicated that Taiwan's services sector, particularly financial services firms, had great potential for further development. He said that the financial service sector has been catching up to the manufacturing sector in production, with a ratio between these two sectors narrowing from 32:100 in 1984 to 84:100 in 2004. According to Schive, taking bank

offices as an example, the number of bank offices for every 100,000 persons in Taiwan is 27, less than over 40 in Germany, France and Italy. The number of bank employees serving every 100,000 persons in Taiwan is 551, also less than 600 - 800 in the United States and Europe.

PAAL